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In the Matter of)
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Price Cap Performance Review) CC Docket No. 94-1
for Local Exchange Carriers)

February 28, 1995

EX PARTE

The Honorable Reed Hundt
Chairman
Federal Communications Commission
1919 M Street, NW
Washington, D.C. 20554

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Dear Chairman Hundt:

We are writing to express our views in the above referenced proceeding. We believe that in order to best achieve the public interest goals established by the Commission[1] when it first adopted the price cap rules, the Commission should (1) remove the vestiges of rate of return regulation from the local exchange carrier (LEC) price cap rules, and (2) establish the pricing flexibility that the LECs need to operate in a competitive environment.

On the surface the price cap performance review is about payments among providers of telecommunications services. Specifically, how much should the nation's interexchange carriers (IXCs) pay LECs for access to the local telephone network. At stake, however, is much more.

The undersigned are professors of consumer affairs. We believe that the public interest is best served by modernizing our nation's telecommunications infrastructure to meet the needs of users who rely on the public switched network. The public interest should not be confused with the more narrowly focused consumer interest. The latter is primarily concerned with obtaining low prices for minimally acceptable goods and services. The public interest demands fair prices for a variety of basic and advanced goods and services, innovation, and the ability to respond to new market forces.

The Commission's 1991 decision to adopt modified price cap regulation for local access

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[1] The goals established by the Commission include, "ensuring that LEC rates are just, reasonable and nondiscriminatory and promoting a communications system that offers innovative, high quality services." Notice of Proposed Rulemaking(NPRM). CC Docket No. 94-1. February 16, 1994. at 12.

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rates was in the public interest. Price cap regulation encourages deployment of an advanced telecommunications infrastructure and allows local telephone companies to respond to market pressure on competitive services, while ensuring that basic telephone service, in this case access service, remains available and affordable. We believe that the Commission can further these goals by eliminating the vestiges of rate-of-return regulation from the current price cap regime.

The record in this proceeding is replete with conflicting recommendations to tinker with components of the price cap formula. These competing recommendations reflect the fundamental differences between the narrowly prescribed consumer interest and the more broadly fashioned public interest. The commission has been asked to raise and lower the productivity offset, continue and discontinue sharing, and keep and eliminate the low-end adjustment mechanism. Commenters have suggested that LECs have profited disproportionately from price caps and that LEC earnings are below market averages; that LECs are disinvesting in the local network and the LECs have increased their investment in the network; that the Commission should focus regulation more on earnings and less on prices and more on prices and less on earnings; that the IXC's are passing reductions in access charges through to users and that long-distance rates continue to rise notwithstanding significant cuts in access charges

The Commission has been barraged with these competing claims and recommendations because in 1991 it adopted hybrid rules for access charges that have elements of both price cap and rate of return regulation. If the Commission only tinkers with the rules, it will, during the next review proceedings, confront many of the same contradictory claims and competing recommendations.

To achieve the public interest objectives the Commission established when it adopted the LEC price cap rules, we offer the following recommendations:

I. The Commission should remove the vestiges of rate of return regulation from the LEC price cap rules.

Price cap rules shift the focus of regulation from profits to prices, thereby rewarding efficiency and encouraging investment in the network. Price cap rules protect consumers by setting an initial price and subsequently adjusting it upward and downward to reflect increased productivity and inflation. Price cap rules should also provide certainty. Once a price cap is set, changes should be reasonably predictable to allow LECs to make prudent investment decisions.

To achieve these goals, the Commission should eliminate the sharing requirement and select a reasonable productivity factor that reflects long-term economic trends.

The concept of sharing, which is unique to the LEC price cap rules, is the single most significant remnant of rate of return regulation. It regulates profits and discourages investment and innovation, and is, therefore, incompatible with price cap regulation. Sharing should be eliminated.

The Commission should not increase the productivity factor and, in effect, punish LECs that have exceeded historic productivity gains. Price cap rules are designed, in part, to encourage increased productivity, i.e., doing better than some historic average. The Commission will send conflicting signals if the regulatory reward for increased productivity is further constraints on prices.[2]

Using a productivity factor that reflects long-term economic trends will protect consumers and encourage LECs to do better than the "average" and invest additional earnings in upgrading the local telephone network. This is particularly important as we enter the information age. The local telephone network will be the on and off ramps that connect our homes, schools, libraries, businesses, and health care facilities to the information superhighway. The widespread availability of telemedicine, distance learning, telecommuting, and other services is dependent upon future investment in the local telephone network.

II. THE COMMISSION SHOULD ESTABLISH THE PRICING FLEXIBILITY THAT THE LECS NEED TO OPERATE IN A COMPETITIVE ENVIRONMENT.

LECs face increasing competition for high-volume, low-cost users from competitive access providers (CAPs), cable, and wireless services. While some view the initial forays of CAPs and others as "cream skimming," -- the cream being business consumers concentrated in urban downtowns and new suburban edge cities -- we do not fault them for concentrating their business development efforts in the most profitable and, therefore, competitively vulnerable part of the market. The price cap LECs, however, must have the flexibility needed to address the fundamental changes to the access market that accompany competition.

If the LECs are not given the regulatory flexibility they need to compete for high-volume, low-cost consumers, their ability to provide reasonably-priced, high-quality service in other markets will suffer. The LECs will continue to have the lion's share of universal service and carrier of last resort obligations. Their ability to meet these obligations while competitors cream skim their most lucrative access customers can only be assured by allowing them to compete on a level regulatory playing field. This is best achieved by fully deregulating access rates in markets that have competition.

Conclusion:

The Commission can best achieve its stated goals by removing the vestiges of rate of return regulation from the LEC price cap rules and establishing the pricing flexibility that the LECs need to operate in a competitive environment. The public interest in a communications system that offers innovative, affordable, high quality services will be best served by a

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[2] The Commission recognizes that one important objective of price cap rules is to give the carrier, "the opportunity to earn higher profits, but...only by operating more efficiently or by developing new services customers want, not by raising overall prices." NPRM at 4. This goal would be obviated if all efficiency gains resulting from increased productivity were simply passed through to customers in the form of lower access rates.

regulatory regime that encourages investment in the public telephone network. The Commission can achieve these goals by eliminating the sharing requirement, establish a reasonable productivity factor that reflects long-term economic trends, and deregulating access rates in markets that have competition from CAPs, cable, wireless service providers or other providers of access services.

Sincerely,

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